

# CONSERVATION EASEMENTS

## as Income Tax Deductions

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Photo by Coleen Vansant

**P**reservation of aesthetic, environmental, historic, and recreational values on private lands is difficult to accomplish. Government entities often do not have the funding to purchase and preserve these lands in an undeveloped state. Income tax incentives in return for the donation of conservation easements by private landowners provide a useful tool for accomplishing these preservation goals.

The Internal Revenue Code (hereinafter “the Code”) allows for income tax deductions for charitable contributions under Section 170. One type of these charitable contributions is a conveyance of a partial property interest, which qualifies under the Code as a “conservation contribution.” The most common form of these contributions is a conservation easement. Conservation easements were only relatively recently authorized in 1997 as a valid property interest under Alabama law. The charitable conservation contribution must meet specific requirements outlined in the Code and Treasury Regulations (hereinafter “the Regulations”) in order to qualify for the income tax deduction. A qualified conservation contribution is generally defined by the Code as “a contribution of a qualified real property interest, to a qualified organization, exclusively for conservation purposes.”

### Statutory Requirements

The conservation easement (i.e. restriction on use of the property) is the most common type of qualified real property interest donated. It is best suited to landowners who want to retain certain uses of their property while restricting the property from future development and/or preserving certain characteristics of the property.

Generally, under the Regulations the qualified receiving organization must “have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions.” The Regulations identify the types of organizations qualified to receive conservation contributions as governmental units, organizations receiving substantial support from a governmental unit, and tax-exempt publicly-supported charities qualified under 501(c)(3) of the Code.

The Code states that, “contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.” Surface mining is generally prohibited. Further, the Regulations require the taxpayer to substantiate the condition of the property at the time of gift by providing the receiving organization with appropriate baseline documentation where a retained use may potentially impact the donated conservation purpose

in the future. The Tax Court recently interpreted this exclusivity requirement to also necessitate that a tax-exempt organization's formal exempt status purpose be related to holding the conservation easement, and that it be able to enforce its rights as such holder.

The conservation purpose requirement is more difficult to ascertain than the other requirements because every tract of land possesses a unique mix of conservation values. The Code identifies four general classes of conservation purposes:

- 1) The preservation of land areas for outdoor recreation by, or the education of, the general public;
- 2) The protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem;
- 3) The preservation of open space (including farmland and forestland) where such preservation is – for the scenic enjoyment of the general public, or – pursuant to a clearly delineated federal, state, or local government conservation policy and will yield a significant public benefit; or
- 4) The preservation of a historically important land area or a certified historic structure.

The Regulations attempt to further define these broad categories and provide some specific examples; however, it is impossible to identify the infinite different circumstances which qualify as con-

servation purposes. The Regulations do identify that public access is required where the conservation purpose is for the preservation of land areas for outdoor recreation by, or the education of, the general public. Public access is not required to accomplish the other general categories of conservation purposes except where the lack of public access would frustrate the proposed conservation purpose.

Given the wide variety of individual circumstances that would qualify as conservation purposes, the determination is inherently a case by case analysis. The only certain way to determine whether a particular taxpayer's contribution will qualify for a conservation deduction is to request a Private Letter Ruling (PLR) from the Internal Revenue Service (IRS). The problem with requesting a PLR is that it is costly and time consuming. Additionally, the IRS will not rule on whether the valuation of the deduction (discussed below) is correct.

While requesting a PLR often is not an appropriate course of action for determining how to create a conservation easement that will qualify for an income tax deduction, analysis of past PLRs provides useful insight into how to structure the transaction. It should be noted that a PLR applies solely to the taxpayer who requested it.

Forty-five PLRs issued between 1982 and 2004 were found which directly addressed the issue of whether a particular easement constituted a qualified conservation contribution to provide the taxpayer an income tax deduction. The rulings involved a wide variety of conservation purposes, and were all determined to be valid conservation contributions pursuant to the Code. This high approval rate could be attributable to the fact that a taxpayer would not undertake the effort and expense to obtain a private letter ruling without presenting a strong case.

Further, it may reflect that the qualified organization receiving the easement helps ensure the significance of the donation. On the other hand, it may simply indicate a somewhat tolerant approach by the IRS in the interpretation of conservation purposes under the Code, given the volume of litigation in regards to valuation, as discussed below.

another common type found in the rulings. Other easements involved retained uses such as forest management and harvesting, mineral rights, outdoor recreation, water use, limited residential development, commercial campgrounds, summer camps, and guest ranches. Most of the rulings involve some combination of the above-listed uses. Frequently the subject property was located in close

proximity to a public recreation area and/or ecologically sensitive area such as a park, national forest, wildlife refuge, or public body of water. Other properties were located in areas that are experiencing rapid growth and development, or contained rare plant or animal species.

## Easement Valuation

The value of the conservation contribution is the fair market value of the restriction at the time of the contribution. Such fair market value can be determined through a comparable sales appraisal approach using sales of similar easements in the area; however, such information is often limited. Therefore, the fair market value of the contribution will often be determined as the fair market value of the property prior to donation of the easement (its highest and best use) less the fair market value of the property after donation of the easement. The Regulations provide that such before-

and-after valuation "must take into account not only the current use of the property, but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use."

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Review of the PLRs showed that often the conservation easements involved contributions which asserted they fulfilled several of the broad categories of conservation purposes identified in the Code. The easements commonly involved agricultural/livestock farms or ranches. In general, these taxpayers proposed to restrict the land from commercial and residential development while continuing farming/ranching activities. Historic preservation easements were

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A deduction in excess of \$5,000 for a donation of a conservation easement must be substantiated by the submission of a qualified appraisal by a qualified appraiser. The intangible nature of conservation easements can lead to widely varying opinions as to value of the easement by equally qualified appraisers. Thus, large deductions for conservation easement donations seem to provide potential fertile ground for IRS audit. Last year, The Joint Committee on Taxation referred to such valuation difficulties in justifying its recommendations for significant revised limits on the allowable charitable deductions for donations of qualified conservation easements. Further, the IRS announced the targeting of abusive practices with conservation easement donations such as over-valuation and failure to enforce easement restrictions.

Indeed, as mentioned above, much of the past litigation in this area has been

regarding the valuation of the donation. In some cases, the IRS has taken the position that the easement donation was worth nothing, arguing that there has been no change in highest and best use of the property. Overall review of cases regarding conservation easement valuation indicates a general trend of the Courts to recognize at least some value for the conservation contribution, usually (but not always) somewhere between the extremes of valuations presented by the taxpayer and IRS experts.

A review of the cases listed in the adjoining table clearly demonstrated that the valuation of a conservation easement is a highly fact-based inquiry and largely dependent on expert



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Case	Taxpayer	IRS	Court
Browning v. CIR(1997)	\$254,000	\$0	\$209,000
Schwab v. CIR(1994)	\$900,000	\$0	\$544,000
Dennis v. U.S.(1992)	\$50,610	\$7,700	\$50,610
Clemens v. CIR(1992)	\$910,000	\$110,000	\$703,000
Schapiro v. CIR(1991)	\$595,031	\$388,000	\$595,031
Dorsey v. CIR(1990)	\$245,000	\$46,000	\$153,422
Higgins v. CIR(1990)	\$110,000	\$50,150	\$103,000
Griffin v. CIR(1989)	\$195,000	\$35,000	\$70,000
Richmond v. U.S.(1988)	\$150,000	\$59,000	\$59,000
Losch v. CIR(1988)	\$235,000	\$70,000	\$130,000
Fannon v. CIR(1986)	\$236,752	\$0	\$90,956
Symington v. CIR(1986)	\$150,000	\$0	\$92,370
Todd v. CIR(1985)	\$353,000	\$31,000	\$31,000

opinion. Proof of the change, due to the easement, in the highest and best potential use of the property has been shown to be instrumental in supporting valuations of the easement, and thus, the deduction taken by the taxpayer. ☛

*NOTE: IRS CIRCULAR 230 Disclosure: U.S. Treasury Regulations require that the reader be informed that any tax advice contained in this article is not intended to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code.*

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